June 7, 2024

Fifth Circuit Vacates Private Fund Adviser Rule

On June 5, 2024, the U.S. Court of Appeals for the Fifth Circuit issued a decision in a case brought by six private fund industry groups challenging the U.S. Securities and Exchange Commission's (the "SEC" or the "Commission") Private Fund Adviser Rule (the "Rule"). In *National Association of Private Fund Managers* v. *SEC*, No. 23-60471, a unanimous three-judge panel of the Fifth Circuit vacated the Rule, which, if implemented, would have imposed extensive new restrictions on the business activities of private fund advisers, along with extremely substantial new disclosure requirements. The Fifth Circuit held that the SEC had exceeded its statutory authority in adopting the Rule, which the Court held was not authorized by either Section 211(h) or 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act").

Because the Fifth Circuit vacated the Rule in its entirety, no part of the Rule will go into effect. The Court's ruling thus represents a significant victory for the private fund adviser industry, which broadly objected to the Rule as unduly burdensome, difficult to implement, costly for investors, and ultimately detrimental to the dynamics of the private fund industry as a whole.

More broadly, the Fifth Circuit's decision could pose significant challenges to the SEC's ability to adopt and enforce rules regulating private fund advisers in the future. This is due in particular to the Fifth Circuit's narrow interpretation of Section 206(4), a key antifraud provision under the Advisers Act, that the SEC has relied upon as statutory authority for many of its rules, both proposed and adopted, that regulate the activities of private fund advisers.

Should it wish to do so, the SEC now has 45 days to seek rehearing from the full Fifth Circuit *en banc* and 90 days to petition the U.S. Supreme Court for review. In the meantime, because the Fifth Circuit has vacated the Rule in its entirety, the Rule has no effect and private fund advisers are not subject to any of its regulations or limitations.

Background on Private Fund Adviser Rule and Litigation

The SEC adopted the Rule in August 2023. The Rule comprised several related regulations that, among other things, imposed new disclosure requirements and prohibitions relating to the granting of preferential treatment to investors (e.g., through side letters), quarterly fee, expense and performance reporting obligations, annual audit requirements for all private funds, and disclosure and/or consent requirements relating to certain allocations of fees and expenses (such as regulatory, compliance and investigation costs).

In response to the adoption of the Rule, in September 2023 a coalition of industry groups led by the National Association of Fund Managers (the "Petitioners") challenged the Rule in the Fifth Circuit. The Petitioners made three arguments for setting aside the Rule, asserting that: (i) the SEC exceeded its statutory authority in issuing the Rule; (ii) the SEC adopted the Rule without meeting notice-and-comment requirements for federal regulations; and (iii) the Rule was arbitrary and capricious and otherwise unlawful.

The parties' arguments focused primarily on whether the SEC had authority to issue the Rule under the Advisers Act. The SEC located its authority for the Rule in two sections of the Advisers Act: Section 211(h), which was added in 2010 through Congress's passage of the Dodd-Frank Act, and the preexisting antifraud authority in Section 206(4). The SEC relied heavily on

© 2024 Paul, Weiss, Rifkind, Wharton & Garrison LLP. In some jurisdictions, this publication may be considered attorney advertising. Past representations are no guarantee of future outcomes.

Dodd-Frank, arguing that, through the Dodd-Frank Act's addition of Section 211(h) to the Advisers Act, Congress specifically granted the Commission rulemaking authority to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest", and to "prohibit[] or restrict[] certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the [SEC] deems contrary to the public interest and the protection of investors". According to the SEC, these provisions were applicable to the activities of private fund advisers that it sought to regulate through the Rule.

The SEC also relied on its preexisting antifraud rulemaking authority in Section 206(4) of the Advisers Act. Section 206(4) authorizes the Commission to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative" regarding "any investment adviser." The SEC thus argued that it had the authority under Section 206(4) to adopt prophylactic rules reasonably designed to prevent fraud or deception, and that, even in the absence of Section 211(h), Section 206(4) alone was sufficient to support the SEC's regulation of private fund adviser activities under the Rule.

The Petitioners argued in response that neither Section 211(h) or Section 206(4) provided the SEC with authority for the Rule. More specifically, they argued that, when viewed in the broader context of the Dodd-Frank Act, it is clear that Section 211 of the Advisers Act applies only to "retail customers," meaning non-professional investors, and not to private funds. The Petitioners argued that if Congress had intended to give the SEC the authority to so broadly restructure the business model of private funds, Congress would have done so more clearly. The Petitioners likewise argued that Section 206(4) of the Advisers Act was inapplicable because the SEC never defined the fraud or explained how the Rule was designed to prevent such fraud.

The Fifth Circuit's Unanimous Decision

In a unanimous decision authored by Judge Kurt D. Engelhardt and joined by Judges Leslie H. Southwick and Cory T. Wilson, the Fifth Circuit concluded that the SEC had exceeded its statutory authority under the Advisers Act and that neither Section 211(h) or Section 206(4) authorized the SEC to adopt the Rule. Because it held that the SEC exceeded its statutory authority, the Court did not reach the Petitioners' other arguments.

In its opinion, the Fifth Circuit rejected the SEC's argument that the Dodd-Frank Act significantly expanded the SEC's rulemaking authority with respect to private fund advisers in Section 211(h). The Court emphasized that Congress has historically drawn a sharp line between private funds, which are subject to limited federal regulation, and funds that serve retail customers, which are subject to extensive regulation under the Investment Company Act of 1940. As the Court explained, "Congress clearly chose *not* to impose the same prescriptive framework on private funds" that it did on retail funds, and the passage of the Dodd-Frank Act in 2010 did not fundamentally alter this framework. The Court recognized that Dodd-Frank also eliminated private fund advisers' exemption from registration with the SEC, making them subject to certain requirements applicable to other investment advisers. However, the Court emphasized that these new requirements were limited. As the Court observed, the "Dodd-Frank Act only stepped towards regulating the relationship between the advisers and the private funds they advise," and did not otherwise overhaul the regulatory framework for private funds first set out by Congress in 1940.

The Court then addressed the two specific provisions relied on by the SEC and concluded that neither supported the Rule. The Court first addressed the SEC's reliance on Section 211(h) and held, as the Petitioners had argued, that that provision applies only to retail customers: in the Fifth Circuit's words, "[i]t has nothing to do with private funds." The Court explained that "[o]nly Title IV [of Dodd-Frank] introduced provisions to regulate private fund advisers," but that the addition of Section 211(h) fell under a different title of Dodd-Frank, separate from the limited provisions expressly related to private fund advisers. The Court noted that the statutory text within this title repeatedly refers to items to "consider" concerning "retail customers" and mentions "retail customers" at least 30 times. Reading the statute in this context, the Court rejected the SEC's argument that Section 211(h) applies to private fund advisers.

The Court next addressed the SEC's reliance on Section 206(4), concluding that the Rule's "'anti-fraud' measure is pretextual," and the SEC did not show how the Rule's reporting and disclosure requirements were rationally connected to preventing fraud. The Court found that Section 206(4) requires the SEC to "define" a fraudulent act or practice before the SEC can issue rules designed to prevent that fraudulent act or practice, but the SEC had largely failed to do so here, noting that the SEC had observed misconduct by only "about 0.05% of [private fund] advisers." The Court also agreed with the Petitioners that the Rule was not "reasonably designed" under Section 206(4). As the Court reasoned, the internal governance structures of private funds have long been dictated not by federal regulation, but instead by contractual negotiation among sophisticated parties, and the SEC could not issue rules "under the guise" of its "anti-fraud" provision to modify the governance structure of private funds.

The Court further concluded that Section 206(4) does not itself authorize the Commission to require disclosure and reporting, and so the SEC would have to rely on other parts of the Advisers Act for the Rule's disclosure and reporting requirements. The Court also found that requirements within the Rule that mandated "disclosure" to investors were not necessarily designed to prevent fraud—as the Court explained, absent a duty to disclose there can be no fraud, and the private fund adviser's disclosure duty under the Advisers Act is to the fund itself, and not investors in the fund.

Next Steps

Looking ahead, the Fifth Circuit's opinion could have significant implications on the SEC's other rulemaking initiatives under the Advisers Act. While the SEC has made clear its interest in further regulating the private fund industry, the Fifth Circuit has now taken a strong stance on the SEC's limited statutory authority in this space, and the Court's opinion may pose significant challenges for the SEC to regulate private fund advisers absent a more clear rationale for how proposed rules are designed to prevent potential fraud or fit within the existing statutory framework governing private fund advisers, as well as require a substantial evidentiary showing as part of the administrative rulemaking process. In addition, the Fifth Circuit's narrow interpretation of Section 206(4) may impact even existing SEC rules that rely on this antifraud provision to regulate the activities of private fund advisers. On the other hand, while the Fifth Circuit has adopted a narrow view of the SEC's statutory authority, it is possible that other circuit courts would not follow the Fifth Circuit's decision in any future challenges. And, of course, this decision remains potentially subject to review by the United States Supreme Court.

We will continue to monitor this case and any related developments. Please direct any questions or inquiries to the Paul, Weiss Investment Fund Litigation team.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Jessica S. Carey
+1-212-373-3566
jcarey@paulweiss.com

Andrew J. Ehrlich
+1-212-373-3166
aehrlich@paulweiss.com

Victoria S. Forrester
+1-212-373-3595
vforrester@paulweiss.com

David P. Friedman
+1-212-373-3935
dfriedman@paulweiss.com

Udi Grofman
+1-212-373-3918
ugrofman@paulweiss.com

Brad S. Karp
+1-212-373-3316
bkarp@paulweiss.com

Gregory F. Laufer
+1-212-373-3441
glaufer@paulweiss.com

Marco V. Masotti
+1-212-373-3034
mmasotti@paulweiss.com

Aaron J. Schlaphoff
+1-212-373-3555
aschlaphoff@paulweiss.com

Jennifer Songer
+1-202-223-7467
jsonger@paulweiss.com

Brette Tannenbaum
+1-212-373-3852
btannenbaum@paulweiss.com

Associates Brian M. Lipshutz and Christine L. Mayberry contributed to this Client Memorandum.